Article Information

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Blockchain Bites: Kraken avoids crack down after SEC settlement, Developers' duties back on trial with Tulip action, Dubai releases virtual asset regulations, Hermes wins NFT infringement lawsuit

Michael Bacina, Steven Pettigrove, Jake Huang, Luke Misthos and Lola Hickey of the Piper Alderman Blockchain Group bring you the latest legal, regulatory and project updates in Blockchain and Digital Law.

Kraken avoids further crack down after SEC settlement

Payward Ventures Inc. and Payward Trading Ltd, the two entities behind global crypto exchange Kraken, have announced an end to their ongoing on-chain staking program which attracted the attention of the Securities and Exchange Commission (**SEC**) in 2019.

In a blog post, Kraken announced US clients will no longer be able to stake new assets and all previously staked assets will be automatically unstaked. Aside from ETH, which cannot be unstaked and returned until the Shanghai upgrade, all staked digital assets will be returned to client's spot wallets.

Prior to the settlement, the SEC alleged Kraken was required to, and failed to register the offer and sale of their staking service under US securities laws. In addition to ceasing the staking service, Kraken has agreed to pay USD$30 million in settlement of the matter.

In a press release the SEC reiterated risks associated with staking:

> *When investors provide tokens to staking-as-a-service providers, they lose control of those tokens and take on risks associated with those platforms, with very little protection.*

Importantly, Kraken's staking service touted specific returns for certain crypto assets which were available on Kraken's website and promoted through email advertisements and social media. Unlike many other staking services, customer returns were not fixed by the underlying blockchain protocol, but were pre-determined by Kraken.

The SEC who argued Kraken was entering into investment contracts with users whereby users would advance tokens and Kraken would supply returns based upon the value of the tokens.

The complaint, which was filed in the US District Court of the Northern District of California asserted that under the *Howey* framework, Kraken had offered and sold its staking program as a security. This case provides an important point of difference with respect to staking services in that staking based on pre-determined rewards, instead of providing rewards resulting from the function of an underlying protocol, involves a greater risk that regulatory bodies will argue token contributors are part of a type of scheme with a view to profit.

There is some similarity with ASIC commencing proceedings in Australia against staking offered by Block Earner and an interest reward program offered by Finder.

Tulip blossoms again: Developers' duties back on trial

The English Court of Appeal has sent back for trial a claim launched by Tulip Trading Limited (**Tulip**) against 16 bitcoin developers which alleges that the developers owed Tulip fiduciary and tortious duties to implement software patches which would enable Tulip to recover bitcoin lost in a hack.

Tulip and its owner, Craig Wright, who has previously asserted that he is the creator of bitcoin, launched the claim against certain core software developers of multiple bitcoin networks seeking the return of access to bitcoins that were stolen from Wright's computer due to a hack. Tulip alleges that the developers owe bitcoin owners a fiduciary duty and a duty in tort.

First Instance

The English High Court rejected these allegations without a trial, finding it was difficult to see how Tulip's case that the developers owed Tulip a fiduciary duty or a duty of care was seriously arguable:

> *The Defendants' evidence was certainly not sufficiently strong to enable me to conclude that [Tulip's] factual case was no more than fanciful.*

Specifically, the lower court found that:

1. An imbalance of power in favour of the Defendants, coupled with a vulnerability under that power imbalance is only an indication of a potential fiduciary duty and not a defining characteristic.
2. Bitcoin owners could only realistically be described as entrusting their property to a "fluctuating and unidentified" body of developers of the software.
3. A distinguishing factor in considering a fiduciary duty is an obligation of undivided loyalty, which is not found in this case.
4. Other users may not agree that a system change sought by Tulip accords with their interests. The changes potentially disadvantage other users.
5. Positive steps sought to be imposed upon the Defendants went well beyond the nature of the action and would likely expose the Defendants to risk.
6. The duties in tort only arise if the Defendants do owe a fiduciary duty. Since there is no fiduciary duty in this case, there is no duty in tort either.

Tulip was unsatisfied with the first instance judgement and appealed to England's Court of Appeal. Lady Justice Andrews granted leave to appeal the first instance decision in August finding that the nature and scope of developers' duties is one of considerable importance and is rightly characterized as a matter of some complexity and difficulty.

The Appeal

While the Court of Appeal did not decide whether there was a fiduciary duty owed by software developers to owners of crypto assets, it allowed the appeal and ordered the case to go to trial, saying it raised a serious issue to be tried.

The Court went on to say that, to rule out Tulip's case as unarguable would require one to assume facts in the Defendant's (i.e. the developers') favour which are disputed and which cannot be resolved without a trial.

Birss LJ, who wrote the Court's joint judgment, did recognise that Tulip's case is not easy to make:

> *I recognise that for Tulip's case to succeed would involve a significant development of the common law on fiduciary duties. I do not pretend that every step along the way is simple or easy.*

Nevertheless, the Court acknowledged there was a realistic argument, along the following lines:

1. The developers of a given network are a sufficiently well defined group to be capable of being subject to fiduciary duties.
2. Viewed objectively the developers have undertaken a role which involves making discretionary decisions and exercising power for and on behalf of other people, in relation to property owned by those other people.
3. That property has been entrusted into the care of the developers. The developers therefore are fiduciaries.
4. The essence of that duty is single minded loyalty to the users of bitcoin software. The content of the duties includes a duty not to act in their own self interest and also involves a duty to act in positive ways in certain circumstances. It may also, realistically, include a duty to act to introduce code so that an owner's bitcoin can be transferred to safety in the circumstances alleged by Tulip.

Conclusion

The outcome of the Tulip case will likely have huge implications on software developers for blockchain projects. While the original decision had been hailed as absolving software developers in blockchain projects from liability, some academics have long argued for a fiduciary relationship and duties of care to be imposed upon online service providers, and by extension software developers. This appeal decision throws the issue back into muddy waters.

If developers were found to owe duties to users to reinstate lost or stolen assets, this would impose a considerable additional compliance and communication burden upon them, as well as potential legal liability. The imposition of these duties could also run counter to the functional separation in many projects between the development of open-source applications, and the use of those applications by users who have no direct contact with the developers.

Tulip Trading is the first case heard by the English Courts to consider the roles and duties of cryptocurrency software developers, and one closely watched by others around the world. That battle will now continue at trial and potentially provide greater clarity as to the legal obligations of software developers. This topic is one that developers and start-ups will need to continue to monitor for some time to come.

Dubai releases virtual asset regulations

Dubai's Virtual Asset Regulatory Authority (**VARA**), the regulator in charge of overseeing cryptocurrency laws within Dubai, has issued the Virtual Asset and Related Activities Regulations. The Full Market Product (**FMP**) regulations are centered around economic sustainability, cross-border financial security and an updated licensing framework.

The regulations offers Virtual Asset Service Providers (**VASPs**) an update regulatory framework with rules that apply to particular operations and business models. Attaining VASP status under the regulations is a 4-stage licensing process whereby applicants progress through a tiered approval gateway.

Stage one is a provisional permit, followed by a two-step stage 2 (preparatory) and stage 3 (operating) Minimum Viable Product (**MVP**) licence. Once the first three stages have been fulfilled entities will be entitled to obtain an FMP licence. To date, no VASP has progressed beyond stage 2.

The regulations provide clarity on, among other things, issuance of virtual assets, regulated activities, licensing requirements, VARA's powers, AML/CTF obligations and marketing regulations and offences.

To assist VASPs in complying with the regulations, VARA has also released a number of rulebooks that provide guidance for VASPs carrying on a specific type of virtual asset service. The following rulebooks have been provided by VARA and must be complied with by any VASP that fulfils the licensing requirements:

- A Company Rulebook that provides guidance for VASPs regarding company structure, governance, general requirements, insolvency and rules on material changes to business or control;
- A Compliance and Risk Management Rulebook which outlines general principles of compliance management, tax reporting compliance, AML/CTF compliance, client money rules, client virtual asset rules and anti-bribery and corruption compliance;
- A Technology and Information Rulebook outlining rules relating to technology governance, controls and security, personal data protection and confidential information; and
- A Market Conduct Rulebook that covers regulations on marketing, advertising, promotions, client agreements, complaints, investor classifications, public disclosures, market transparency and broad prohibitions.

VARA has also released seven activity specific rulebooks to cater for risk associated with the provision of each virtual asset activity. VASPs are only required to comply with the rulebooks insofar as they are licensed to offer the activity. The include:

- An Advisory Services Rulebook to clarify the rules, procedures and public disclosures around VASPs providing advisory services;
- A Broker-Dealer Services Rulebook to clarify the rules, procedures and public disclosures around VASPs providing broker-dealer services;
- A Custody Services Rulebook to clarify board requirements, policies, procedures, public disclosures, asset storage and custody for VASPs providing custody services;
- An Exchange Services Rulebook to clarify the board requirements, policies, procedures, exchange services rules and margin trading rules for VASPs providing exchange services;
- A Lending and Borrowing Services Rulebook to clarify the policies, procedures, public disclosures as well as lending and borrowing services rules for VASPs carrying on a lending and borrowing service;
- A Virtual Asset Management and Investment Services Rulebook to clarify policies, procedures, public disclosures

and management and investment services rules for VASPs handling virtual asset management and investments; and
- A Virtual Asset Issuance Rulebook that outlines approval requirements, whitepaper obligations, compliance obligations and supervision, examination and enforcement obligations for VASPs that plan to issue a virtual asset.

Following the announcements of UK's crypto consultation, the United States' crypto roadmap, Hong Kong's stablecoin licensing regime and Australia's Token Mapping Consultation Paper crypt asset regulation is a key focus of governments this year.

Dubai has become the first nation in the Middle East Africa South Asian (**MEASA**) group of countries to release a comprehensive framework regulating virtual assets and virtual asset service providers. VARA aims to create an easy to replicate framework to regulate the industry.

Other countries, like Australia, will need to review these regulations closely as they seek to regulate the crypto-asset space to ensure jobs and growth remain in those countries.

It's in the bag: Hermes wins NFT infringement lawsuit over Birkin bags

The limits of artistic expression were tested this week as a US jury found that NFTs, featuring the design of the famous Hermès Birkin bag, breached trademark and cybersquatting laws. The dispute surrounds the NFTs "MetaBirkins", which were designed and sold by Mason Rothschild, a NFT artist and replicated the design of the Birkin bag, sold by Hermès. The proceeding is one of the first to address the relationship between digital art, NFTs and the physical fashion it replicates.

On 16 December 2021, Hermès sent a cease and desist letter to Rothschild in relation to the NFT collection, which allegedly made over $1 million in sales. On 14 January 2022, Hermès filed a claim against Rothschild for common law trademark infringement, false designation of origin, trademark dilution, cybersquatting, and injury to business reputation under New York General Business Law. Hermès alleged that Rothschild refused to stop selling the NFTs MetaBirkins and accused Rothschild of:

> *stealing the goodwill in Hermès' famous intellectual property to create and sell his own line of products*

Rothschild responded to the claim via Twitter, alleging that he intended to set a precedent in the art and NFT space and that the claim by Hermès is baseless. Rothschild referenced the letter of support by Campbell Soup Company to artist Andy Warhol in 1964, which praised his artwork featuring the Campbell Soup brand, as a way to bolster his case. Rothschild stated:

> *I am not creating or selling fake Birkin bags. I've made artworks that depict imaginary, fur-covered Birkin bags…The fact that I sell the art using NFTs doesn't change the fact that it's art.*

In March 2022, Rothschild argued that the MetaBirkins NFTs are commentary on the animal cruelty by Hermès and excessive expense of Birkin Bags. Rothchild aimed to rely on the protection of the First Amendment of the U.S. Constitution, stating in the filing that:

> *These images, and the NFTs that authenticate them, are not handbags; they carry nothing but meaning*

In May 2022, Rothschild filed to dismiss the case, which was denied in a one-page order. In October 2022, Hermès pushed for a summary judgment which the judge also denied. On 30 January 2023, the lawsuit officially moved to trial at the U.S. District Court for the Southern District of New York.

One of the key issues in the case has been whether Rothschild's use of the Hermès trademark was artistically relevant or risked misleading consumers as to the sponsorship, endorsement or other connection to the brand.

On 8 February 2023, the jury handed down their decision in favour of Hermès, and found MetaBirkins creator, Mason Rothschild, liable on all three counts and that he is not shielded by First Amendment protections. The jury awarded Hermès roughly $133,000 in damages.

While jury trials often turn on the individual facts of any one case and the views of the jury, the decision indicates the potential limits of artistic expression in the use of trademarks in digital art. Andy Warhol may turn in his grave given the stark contrast to Campbell Soup's reaction to his works.